

Guide to a Discretionary Trust

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Law

The law is as stated 1 January 2018.

Table of contents

What is a Trust?	1
What is a discretionary trust?	1
Operating a trust	2
Open a bank account.....	2
Minutes/Resolution for annual income distribution	2
Investments.....	2
Consider registration for the tax system	2
What are the benefits of a discretionary trust?	2
When does a discretionary trust start?	3
Explanation of other terms in the trust deed	4
The trustee(s).....	4
The appointor(s).....	6
The trust fund	7
The beneficiaries.....	8
Traps for the unwary	8
Estate planning	8
Features of the Trust Deed	10
Instructions on how to execute the Discretionary Trust deed	11

What is a Trust?

A trust is a relationship where a person (the trustee) is under an obligation to hold property for the benefit of other persons (the beneficiaries).

EXAMPLE

Rob is an accountant in practice and has a risk of being sued for negligence. Rob is also a single parent and has two children, Jack and Jill, aged 10 and 12. Rob wishes to provide for his children if anything ever happened to him.

Rob asks his brother Tom, to “hold” certain income producing assets on behalf of Jack and Jill.

Rob instructs Tom in writing that he (Tom) will be the legal owner of the property, but any income flowing from the assets will only accrue to Jack and Jill.

The above arrangement is a form of trust relationship as follows:

- **Trustee** – Tom;
- **Beneficiaries** – Jack and Jill;
- **Trust deed** – Rob’s instructions to Tom.

A trust is not a separate legal entity, even though, for tax law purposes, a trust return is required to be lodged.

A trust cannot exist forever. The trust comes to an end on the “Vesting Day”, and for most trusts (except those in South Australia) this day must generally occur within 80 years of the establishment date.

What is a discretionary trust?

A discretionary trust is generally a trust under which the distribution of income or capital to beneficiaries is made at the discretion of the trustee. Until the trustee exercises its discretion, the beneficiaries generally have no interest in the property of the trust. A discretionary trust is sometimes called a “family trust” (however, for tax purposes, a “family trust” is defined to mean a trust that has made a “family trust election”).

EXAMPLE

Discretionary trust

The trust deed of the XYZ Family Trust provides that the income and capital of the trust can be distributed to the beneficiaries of the trust as determined by the trustee each year. This is a discretionary trust.

Not a discretionary trust

Jack and Diane own half of the units each in The ABC Unit Trust. This is not a discretionary trust.

Strictly speaking, a person to whom the trustee can distribute income or capital is only a **potential** beneficiary and not an actual beneficiary **until the trustee exercises their discretion** and actually makes them entitled to income or capital. Until this time, the beneficiary has no rights except to be **considered** as a potential candidate for a distribution of income or capital.

Nonetheless, in practice, people generally refer to a “potential beneficiary” as a “beneficiary”.

EXAMPLE

The XYZ trust is set up with a wide range of beneficiaries, including Mr A and all of his family. Mr A and his family are merely only potential beneficiaries at this time. At the end of the trust's first year of operation, the trustee resolves to distribute the trust income to Hank, a child of Mr A. Hank is now a **beneficiary** under the trust with a recognisable interest in the income of the trust, whereas the rest of the family are still only potential beneficiaries.

Operating a trust

There are a number of important issues to consider in relation to operating a trust.

Open a bank account

After the deed is executed, the trustee should arrange for a bank account to be set up as soon as possible. The name on the bank account should be along the lines of the following:

EXAMPLE ONLY – ZBC Pty Ltd as Trustee for the FGH Discretionary Trust.

The bank can provide details of the information required to open up a new bank account.

Where a corporate trustee has just been set up as well, the company provider may provide a bank kit to assist with opening up a new bank account (we provide such a kit).

TAX WARNING – Trust bank account not for personal use

The bank account used by the trust should not be used as a personal bank account. This is because adverse tax consequences may arise where beneficiaries draw money for their own use. If money is required from the trust, please contact your accountant before drawing the funds. He or she can then advise you of your tax options in relation to drawing down the funds.

Minutes/Resolution for annual income distribution

As well as maintaining records it is important that the trustee holds a meeting (or otherwise resolves) on or before 30 June each year to allocate the income of the trust among the beneficiaries. Please contact your accountant for information on how the meeting should be documented.

Investments

Trustees often have unlimited powers in deciding in what to invest. The trustee's powers are set out in the trust deed, but the trustee has a responsibility to exercise skill and care in making their investment decisions. This rule basically says that the trustee should ensure they take the same degree of care that a prudent person would take in making investment decisions, given their skills and knowledge.

Consider registration for the tax system

There are a number of tax obligations that the trust may have to register for, including GST, PAYG withholding and so on. In this regard, advice should be obtained from your accountant.

What are the benefits of a discretionary trust?

The benefits of a discretionary trust include the following:

- Potential asset protection;

Guide to a Discretionary Trust

- The trustee has flexibility regarding the distribution of income and capital;
- Less regulation than a company;
- The trust deed can be tailored to the needs of principals and beneficiaries; and
- Easier to wind up than a company.

One of the main advantages of a discretionary trust is the ability to distribute income and capital tax-effectively. The trustee is able to either distribute income to the beneficiaries or accumulate it (although accumulating causes its own problems – i.e., the trustee may be taxed on such amounts at the top tax rate). None of the beneficiaries are able to force the trustee to distribute income in a particular way.

The principal benefit of using a trust to carry on a business or hold assets is that no single beneficiary has any claim to any assets of the trust (apart from any unpaid distributions they remain entitled to) and therefore a trust provides a good way to obtain asset protection.

EXAMPLE

Madison is listed as a beneficiary of the Plastics Family trust. Madison borrows to invest in speculative shares and encounters financial difficulties. The bank forecloses on Madison's home to recoup some of the lost borrowings. As Madison has no claim on (and does not own) the trust property, the bank should not be able to force the Plastics Family Trust to sell its assets to pay Madison's debt.

When considering asset protection issues, reference should also be made to page 6 of this Guide for a discussion about the role of an appointor in a trust.

TRUST WARNING – Trust assets may still be at risk

In a recent company law case called "*Richstar*", the Federal Court held that, where a beneficiary of a discretionary trust effectively controls that trust (e.g., they are the trustee or the appointor), then "there is something which is akin to a proprietary interest in the beneficiary". However, the Court only came to this conclusion in relation to a particularly broad section of the *Corporations Act 2001* that allows the Court to freeze the assets of certain entities on the application of ASIC while other matters remain unresolved, and it has not been followed subsequently in relation to (for example) bankruptcy law.

Nonetheless, that case (and other similar cases, including Family Law cases), highlight that a *potential* beneficiary of a discretionary trust, particularly where they play other roles in relation to running the trust, may still be found to have an "interest" in the assets of the trust.

When does a discretionary trust start?

A discretionary trust is created when a person known as the "settlor" gives the trustee money or property for the benefit of the beneficiaries. This "settled sum" is the original trust fund. The settlor is normally a family friend and should not be a beneficiary of the trust, nor should they be the client's professional adviser or anyone similar if it could be argued that the settled sum has been refunded back to them. No other legal obligations arise for the settlor, who is not responsible in any way for the trustee's actions.

EXAMPLE – Discretionary trust starting

Jill is a family friend of the Natt family. Jill gives \$20 to Bill Natt to hold on trust for the benefit of the Natt family. A trust has now started.

TRUST TIP – Further evidence of trust being established

It is often a good idea for the trustee to open a bank account to deposit the settled sum shortly after the deed has been executed (if the trustee is a company set up by us, the included directors' resolution assumes this will be done) – this can provide further evidence regarding the date the trust was settled. Some trustees prefer to staple the settled sum to the deed, so as to ensure it is not eroded by bank fees, but this can also be dangerous if the original deed is lost (meaning the settled sum is completely lost). However, if a corporate trustee would prefer to take this alternative option, they should amend the directors' resolution accordingly.

A trust deed may be subject to stamp duty. The stamp duty (if any) can vary from one State or Territory to another, and the deed normally needs to be stamped within a limited time period after being executed – contact the relevant State Revenue Office for more details.

Explanation of other terms in the trust deed

The trustee(s)

The trustee is the legal owner of the trust property, although not the beneficial owner, and is responsible for managing the trust fund. Being the legal owner, all of the transactions of the trust are carried out in the name of the trustee. The trustee signs all documents for and on behalf of the trust, i.e., in its capacity as trustee of the trust.

As a trust is not a separate legal entity, the trustee bears the duties and responsibilities in relation to the trust. As such, the trustee is personally liable to creditors and accountable to beneficiaries.

TRUST TIP – Limitation of trustee's liability

The trustee can limit their personal liability by making it clear that any contract or promise is supported by the trust's assets only and not by the trustee's own personal assets. In particular, special care should be taken when entering into finance arrangements, as many finance documents will have a clause stating that the trustee enters into the obligations in a personal capacity as well as their capacity as trustee.

The trustee should ideally make it clear that they are contracting in their capacity as trustee and not on their own behalf and should consider inserting a specific clause in every contract to limit liability.

If this is not possible, the trustee should at least insert the following words after their name "as trustee only but not otherwise". The above procedures are recommended but cannot be relied upon to fully protect the trustee. Also refer to the Trust Warning on the next page.

The trustee's overriding duty is to obey the terms of the trust deed. The trustee also has a duty to act in the best interests of the beneficiaries. There are many other duties imposed on the trustee by law. In summary, these are:

- Trustees must carry out the terms of the trust;
- Trustees must act in good faith;
- Trustees must preserve the trust assets;
- Trustees must exercise reasonable care in the administration of the trust;
- Trustees must not benefit from their position as trustee;

Guide to a Discretionary Trust

- Trustees must not put themselves in a position of conflict of compromise;
- Trustees must keep proper accounts and records.

EXAMPLE – Trustee complies with duties

Donald is the trustee of the Duck Discretionary Trust. The beneficiaries of the Duck Discretionary Trust are Daisy, Huey, Duey and Looyey.

On 29 June, Donald resolves to distribute the income of the Duck Discretionary Trust.

Provided Donald *considers* all four beneficiaries in light of his duties, he will not breach his duty if he then exercises his discretionary power and decides to distribute *all* of the income to Daisy.

TRUST WARNING – Trustee must act in beneficiaries' best interests

Unless the trust deed specifically allows it, Donald, as trustee, cannot exercise his powers in his own favour. For example, he could not borrow money in his own capacity from the trust interest free and without security unless the trust specifically allowed it. Similarly, if Donald was also a beneficiary he must take care when exercising his discretion to distribute income to himself. An improper exercise of that discretion to advance his own interest will constitute a breach of trust.

The Australian Business Structures Trust Deed *does* allow a trustee to be a beneficiary of the trust and to act even if the trustee has a personal interest in the result of the decision/action, but the trustee must still act in good faith and in the interests of the beneficiaries.

In addition to a trustee's duties, which the trustee *must* carry out, the trustee also has the choice to use "powers". Powers under many trust deeds include the power to buy assets, dispose of them at any time, mortgage assets for the purposes of undertaking borrowings, and so on.

Who should be the Trustee?

As the trustee is personally liable for the debts and transactions they undertake on behalf of the trust, best practice is to use a company as trustee, for the following reasons:

- It is easier to effect changes of control;
- A company never dies – this saves the expense of transferring assets to new trustees on the death or retirement of the existing trustees; and
- It can provide good asset protection, especially if the company has no other significant assets of its own (i.e., if its only role is to act as corporate trustee) which could be exposed to the creditors of the trust.

TRUST WARNING – Directors may still be liable

A corporate trustee will not provide total protection. Even with a corporate trustee, there may be circumstances in which a director of a trustee company is personally liable, including:

- taxation offences committed;
- certain unpaid taxes or superannuation guarantee;
- taking on debts which the directors know the corporate trustee is unable to repay;
- taking on debts which are not permitted under the trust deed; or

Guide to a Discretionary Trust

– where the director gives a personal guarantee.

In addition, there is a risk in some circumstances that the “corporate veil” will not work before a court of law.

Although there are circumstances in which the corporate trustee can be personally liable, a corporate trustee still generally offers greater asset protection than an individual being the trustee. Therefore, it is recommended that, where possible, a company should be the trustee.

Should different trusts have different trustees?

It is generally preferable to have separate trustees for the following reasons:

- it avoids the need to prove which assets belong to which trust. If two trusts have the same trustee and one gets into financial difficulty, it could be extremely costly for the trustee to prove which assets are beneficially owned under which trust; and
- there is a risk that a creditor could get access to the assets of all trusts for which the trustee acts, i.e., creditors of one trust may access assets of the others.

Trustee’s right of indemnity

If a trustee’s liability arose from the proper exercise of their powers and duties, the trustee can be ‘indemnified’ out of the trust assets. Broadly, this means the trustee can pay expenses from trust funds, instead of their own, or be reimbursed by the trust if they do personally pay for trust expenses (although, if the assets of the trust fund are insufficient to meet the expenses, the trustee may be personally liable for such expenses).

A trustee can lose their right of indemnity if, for example:

- they do not act within their powers;
- the expense or liability has not been properly incurred;
- the trustee has not acted with reasonable diligence; or
- the trustee has breached their duty.

EXAMPLE – Trustee loses right of indemnity

Francis is the trustee of the Black Trust. As trustee, Francis purchases speculative share investments, which go bad. Francis has no experience in share trading and relies on tips from friends.

Francis may have to pay for the losses from his own personal funds as, arguably, he has not acted diligently in choosing an investment.

The appointor(s)

The appointors (or appointor) of a trust have the real power and control of the assets of a trust, since the appointors have the power to appoint and remove trustees. In many cases, the original appointors include the one or more of the parties for whose benefit the trust is established.

If there is no appointor named in the trust deed, then our deed allows the trustee to exercise the powers of the appointor (although for other deeds it may be necessary to refer to the Trustee Act of the State or Territory concerned to work out how a trustee can be removed/appointed).

Who should be the appointor?

As the real control of a trust lies with the appointor, extreme care should be taken in choosing the appointor. Generally, having a number of joint appointors, possibly including an independent appointor, provides greater asset protection and succession planning benefits, so it is preferable to avoid having a sole appointor.

EXAMPLE – Why a sole appointor should be avoided

Bill decides to establish a family discretionary trust with White Pty Ltd as trustee. Bill and his wife Pauline are the directors and shareholders of White Pty Ltd. The trust deed states that Bill is the sole appointor and on his death his wife becomes the appointor.

Scenario 1

Six years after the trust is established, the trust has significant assets, and Bill and Pauline separate. Bill, as appointor, removes White Pty Ltd as trustee and appoints his brother (Jed) as the new trustee. Jed distributes all income to Bill. Pauline no longer has any control over the income or capital of the trust.

Scenario 2

Six years after the trust is established, the trust has significant assets, and Bill and Pauline separate. Shortly after separating, Bill dies. Pauline is now the sole appointor and controls the trust.

Consideration needs to be given to the following points when deciding on an appointor:

- what happens on **death, divorce and bankruptcy**.

EXAMPLE – Bankruptcy and divorce

Scenario 3 – Bankruptcy

If a sole appointor, who was also a beneficiary of the trust, was made bankrupt, the trustee in bankruptcy may try to argue that the power of appointment is “property” which vests in him. If successful, the trustee in bankruptcy could then appropriate and exercise that power of appointment to replace the trustee of the trust with himself. Consequently, all the income and capital could be distributed to the bankrupt beneficiary to pay all his creditors. The current state of the law is that the power of appointment is not “property” and so does not vest in the trustee in bankruptcy, but this could change (and a trust may incur significant costs defending such a claim, even if it is not successful).

Scenario 4 – Divorce

It is possible the Family Court could order an appointor to replace the trustee with the Family Court Registrar. The Registrar could then distribute the assets to the husband or wife. Although it is not clear whether the Family Court could take such action (although it does have very broad powers), it is best not to provide it with such an opportunity.

- For ultimate asset protection, it is recommended to have joint appointors with at least one independent appointor. For example, three joint appointors, being the husband, wife and an independent appointor, such as the family solicitor or accountant or a family friend.

To be effective, the appointors’ decisions must be required to be unanimous (thus two could not act against one). This would prevent a trustee in bankruptcy, for example, removing the current trustee without the consent of the independent appointor.

- Alternatively, a company could be made the appointor (although succession issues in relation the directors and shareholders of that company must then be considered, amongst other matters).

The trust fund

The trust fund is all the property of the trust including the settled sum, income accumulated and any other money and property held by the trustee pursuant to the terms of the trust.

The beneficiaries

The beneficiaries are the people (including other entities, such as companies) for whose benefit the trustee holds the property. As mentioned previously, a person to whom the trustee can distribute income or corpus (capital) is a potential beneficiary. A potential beneficiary becomes a beneficiary on the distribution of (i.e., on the exercise of the trustee's discretion to distribute) the income or capital of the trust.

There are different types of beneficiaries, including:

- **Primary beneficiaries**, who will usually be entitled to undistributed capital and income on winding up of the trust and, in most discretionary trusts, will include the immediate family of those for whom the trust is being set up; and
- **General beneficiaries**, who usually include the primary beneficiaries as well as other people set out in the trust deed (including related companies and trusts, and often charities).

TRUST WARNING – Resettlement risk

Care should be taken when a major restructure of the beneficiaries is proposed. The risk is that such a change could mean the trust becomes an entirely new trust – triggering capital gains tax (CGT) and/or stamp duty consequences.

Traps for the unwary

Listed below are some common traps which may be exposed on an ATO audit (and other dangers):

- No dated and stamped trust deeds;
- Shares in a corporate beneficiary are held by the primary beneficiaries – asset protection may not be achieved if this is done;

EXAMPLE – Shares in 'bucket company' held by primary beneficiary

Jason owns shares in a corporate beneficiary that has received or is entitled to receive large distributions from a discretionary trust. Unexpectedly, Jason goes bankrupt. The trustee in bankruptcy calls in all of Jason's assets – one of which is the shares he owns in the corporate beneficiary. This is not a good result.

- The trust bank account was opened some months after the date shown on the trust deed (which then looks like the deed has been back-dated);
- No evidence of the settled sum ever being paid;
- If the trustee is a company, no evidence that the board of directors resolved to accept the position of trustee in accordance with its constitution;
- The terms of the trust deed have not been followed;
- No written minutes/resolutions showing distributions of income or capital; and
- Trustees or beneficiaries using the trust's bank account as their own – which exposes them to tax or other consequences for breaches.

Estate planning

Since the assets of a trust are not owned by any one beneficiary, the beneficiaries cannot deal with those assets or pass them on their descendants by their wills. However, if careful consideration is given to who is and will be the appointor(s) of the trust, control of the trust may be effectively passed to the next generation.

TRUST TIP – Succession planning

An obvious way to pass control of the trust to the next generation is for the trust deed to provide that, following the death of the original appointors of the trust, their children will become the appointors. This will mean that, upon their parents' death, these children will obtain control of the trust (and the trust assets), in the same way that they could obtain other assets directly owned by their parents and passed by will.

A benefit of the assets remaining in the trust, under the control of the children but not directly owned by them, is that should the children (or grandchildren or further descendants) encounter financial difficulty or matrimonial trouble, the assets of the trust should hopefully not be available to their creditors or disgruntled ex-spouses for the life of the trust (at least until the assets or funds are distributed to any of those beneficiaries).

In the meantime, if those beneficiaries require funds, assets or anything else from the trust, the trustee still has the discretion to, for example, distribute income or capital to them or make a loan to them.

Features of the Trust Deed

The following are some of the features of Australian Business Structures Pty Ltd's Discretionary Trust Deed. However, the deed should be read in full to fully ascertain the relationship between the trustee(s) and the beneficiaries.

- The general beneficiary clause is very wide, basically including almost anyone related by blood or marriage to the Primary Beneficiaries, as well as trusts and companies in which they may have an interest, and various charities – refer subclause 1.18.
- If no determination is made to distribute the income of the trust for a particular income year, the income will be held on trust for equal distribution amongst the Primary Beneficiaries aged 18 or more (unless any of them have died, in which case their share will be distributed equally to their children aged 18 or more) – refer subclause 5.4.
- When the trust is wound up (which will effectively be 80 years after the trust commences, unless the trustee decides to wind it up earlier or the trust is in South Australia – refer subclause 1.31) the trustee can distribute the assets of the trust fund as it thinks fit and, if it does not make a determination, they will be distributed to the Primary Beneficiaries (unless any of them have died, in which case their share will be distributed equally to their children, or, if none of them are alive, equally to the general beneficiaries) – refer subclause 6.5.
- The trustee's powers have been drafted as broadly as possible, also allowing the trustee to act as if it is the sole and beneficial owner of the assets of the trust fund, and should include most situations that a trustee will encounter (although note that banks are notorious for requiring very specific powers to be inserted, and may still insist on this despite the trustee having very broad power to act under the deed) – refer clause 13.
- The trustee also has powers to operate the trust as a service entity (if applicable) including powers to, amongst other things, provide secretarial, administration and management services, accounting services, debt collection services, labour services, business premises, plant and equipment, and other services required to support a third party principal entity in running its business – refer clause 13.24. For a service trust arrangement, this trust deed can also be set up in conjunction with our Service Agreement for a Service Trust.
- The trust deed may allow income derived from the investment of property received from a deceased estate (and similar property) to be distributed to minor beneficiaries such that they retain their preferential tax status (i.e. for the income to be taxed at adult rates) – refer clause 11.
- There is a dispute resolving mechanism when there is more than one trustee and they can't reach an agreement – refer subclause 15.3.
- If there is more than one appointor, they must make decisions unanimously (unless the deed has been varied to provide otherwise), and there is a dispute resolving mechanism if they can't reach an agreement – refer subclauses 19.1 & 19.2.
- If the trustee received a testamentary gift (i.e., under the will of a deceased person) and there may be a problem with a technical legal rule known as “the rule against the delegation of testamentary power” (or any other such legal rule or law) then that gift is considered to be held on trust for the beneficiaries existing at the time the trustee receives the gift. New beneficiaries can be added but, if any such technical rules apply, they cannot share in that gift – refer clause 12. Note that this rule is still contentious in Australia, but the clause has been inserted in an attempt to remove doubt.
- It is possible for the trustee to resettle this trust (i.e., the trustee is not prohibited from doing so and may, for example, add new beneficiaries) but **utmost care should be taken** when resettling the trust (or in doing anything that may resettle the trust), due to the adverse tax consequences that may result. Resettling the trust can basically result in a totally new trust arising, and the assets of the old trust being deemed to be ‘sold’ to the new trust, potentially triggering CGT, GST and stamp duty issues. Expert advice should be obtained before doing anything that may resettle the trust.

Instructions on how to execute the Discretionary Trust deed

These instructions should be followed in numerical order:

1. The settlor should give the settled sum to the trustee(s).
2. The settlor, being a natural person (i.e., ordinarily being an individual, not a company) should sign each copy of the deed where indicated in the presence of an independent adult witness, who should then also sign the deeds.
 - (a) if the trustee (or trustees) are natural persons (or any of them are), they should then sign each copy of the deed where indicated in the presence of an independent adult witness, who should then also sign the deeds; or
 - (b) if the trustee is a company (or any of them are, if there is more than one trustee), the company will need to resolve to accept appointment as trustee of the trust before executing the deed. Therefore, the resolution of the director or directors of the company accepting the appointment should be signed and dated and, once this is done, the company can then execute the deed according to its constitution (i.e., with the requisite number of directors and/or secretaries signing the deed, accompanied by an imprint of the common seal of the company, if the company has one and is required to execute documents with it).
3. The trust deed should then be dated where indicated
4. Each copy of the trust deed should then be stamped at the appropriate stamps office and the requisite stamp duty paid according to the State/Territory in which the trust deed is stamped (if necessary) – this will usually be the “Governing State” of the deed (though it is technically possible for a deed to be stamped in one State despite the trust deed specifying that the Governing State is another State – seek advice if you believe this may apply to you).